DRAFT

STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**02/21/03**	Bill No:	**AB 1270**
Tax:	**Sales and Use**	Author:	**Dutton**
Board Position:		Related Bills:	**AB 122 (Calderon)** **AB 651 (Corbett)** **AB 1665 (Runner)** **AB 1674 (Dutra)** **SB 47 (Ackerman)** **SB 137 (Morrow)** **SB 454 (Vasconcellos)** **SB 2X (Poochigian**

BILL SUMMARY

This bill would exempt from the 5 percent state sales and use tax, power generation equipment purchased by new establishments engaged in the generation, transmission and distribution of electricity.

ANALYSIS

Current Law

Under existing law, a sales tax is imposed on retailers for the privilege of selling tangible personal property in this state. The use tax is imposed on the storage, use, or other consumption in this state of tangible personal property purchased. Either the sales tax or the use tax applies with respect to all sales or purchases of tangible personal property, unless that property is specifically exempted.

Existing law, Section 6377 of the Sales and Use Tax Law, provides a 5 percent state sales and use tax exemption for purchases of manufacturing equipment. Under the law, this partial exemption is available only to “qualified persons,” who include only new trades or businesses that are engaged in those lines of business described in Standard Industrial Codes 2011 to 3999 (manufacturers). The partial exemption applies to the following:

- Tangible personal property to be used 50 percent or more in any stage of manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment belts, shafts, computers, software, pollution control equipment, buildings and foundations).
- Tangible personal property purchased for use in research and development.
- Tangible personal property purchased by a contractor or a subcontractor for use in a construction contract for a manufacturer for use in manufacturing, processing, refining, fabricating, recycling, or as a research or storage facility.

- Tangible personal property purchased to be used 50 percent or more in maintaining, repairing, measuring, or testing any exempt manufacturing equipment.

This exemption statute contains a sunset provision based on the number of manufacturing jobs in California. Under the current provision, if the number of non-aerospace manufacturing jobs in California has not increased by at least 100,000 above the comparable 1994 number, the exemption will expire. Each year, the Employment Development Department is required to determine the number of non-aerospace manufacturing jobs, and if the number ever falls below 100,000, the exemption will expire on the next January 1.

Under the Personal Income Tax Law and the Corporation Tax Law, a 6 percent income tax credit on similar property is available to businesses who either do not qualify as a new trade or business under Section 6377, or who would qualify as a new business, but decide to claim the 6% credit rather than the 5% exemption. A similar sunset clause is contained in these laws as well.

Proposed Law

This bill would amend Section 6377 of the Sales and Use Tax Law to include within the 5 percent manufacturers' exemption, the sale or purchase of power generation equipment for use by a qualified person in those lines of business described in Standard Industrial Code (SIC) 4911 (electric power generation, transmission, and distribution).

The bill would also amend the Personal Income Tax Law and Corporation Tax Law to make similar changes to the manufacturers' income tax credit.

The bill would become effectively immediately.

Background

The manufacturer's sales and use tax partial exemption for new manufacturers and the corresponding income tax credit for existing manufacturers were added in 1994 by SB 671 (Stats. 1993, Ch. 881). The purpose of that legislation was to enable California to become competitive with the 42 other states that exempted manufacturing equipment and were luring manufacturers away from California with promises of lower taxes. SB 671 was designed to provide California companies with an immediate incentive to expand their facilities and to create new jobs.

In an October 2002 report put out by the Legislative Analyst's Office, *An Overview of California's Manufacturers' Investment Credit*, the following arguments against and in support of these tax incentives were presented:

Arguments Supporting the MIC

- Investment Incentive—The MIC effectively reduces the price of new capital, and leads to greater investment. Adherents of this view suggest that a firm considering a capital investment is much more likely to undertake such investment with the MIC in place. Proponents argue that this marginal cost reduction can have a significant positive impact on investment decisions.

- Relocation Incentive—California has become a more attractive place relative to other states for business since the credit has been in place. The argument here is that tax credits do influence corporate location decisions and dissuade businesses from moving their activities out of California. Manufacturing industry representatives stated and continue to state that the MIC plays an important role in both expansion and business location decisions.
- Efficient Job Allocator—Competition for business among states is an efficient job allocator. This argument holds that the nation benefits from the redistribution of jobs that may occur due to the use of investment tax credits. This is based on the notion that jobs are worth more in areas with higher unemployment, and that such areas are likely to have relatively aggressive tax credit programs. These areas will be able to attract businesses away from regions that do not value the jobs as highly.
- Other Arguments. Advocates of the MIC also emphasize that the MIC offers significant indirect benefits to the state in terms of investment and job growth that result in additional state revenues. They also point out the importance of manufacturing to the overall state economy in terms of economic stability and the high value-added nature of the employment in this sector.

Arguments Against the MIC

- Inequitable Taxation—The MIC results in giving a tax advantage to manufacturing over other business activities, as well as providing an advantage to capital investment over labor. This view holds that since only one type of industry (and production factor) benefits from the tax credit, the remaining industries face relatively higher costs, and are therefore at a competitive disadvantage. Such preferential treatment can also result in inefficient resource allocation according to this view.
- Relocation Rather Than Creation—The MIC results in few new jobs, but rather pits states against each other in competing for jobs. The argument here is that corporate tax breaks are no more than a transfer of government funds to private businesses, and in the end, the national economy is unaffected. In this view the competition among states in offering various tax incentives represents a form of "prisoners' dilemma"—in which each state would be better off if none offered such incentives. If one state does offer them, however, it is in the interest of other states to do the same.
- Inefficient Development Policy—Tax incentives have a negligible impact on economic growth, and any job creation that does occur does so at a substantial cost per job. Proponents of this view also hold that some of the tax credits will go to companies which would have made the same investments, regardless of the tax incentive. That is, the tax credit did not induce the investment, yet the company receives "windfall benefits" in the form of reduced taxes.
- Ineffective Development Policy—Taxes are a very small percentage of overall business costs and thus have little effect on business decisions. Labor, transportation, land, and other factors typically constitute much more significant proportions of total costs than do taxes. Therefore, according to those who hold this view, tinkering with this particular cost is unlikely to result in a large shift or

expansion of business compared to the adverse fiscal effects that such measures can have on the state.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author. According to the author's office, the purpose of the bill is to increase the incentive for the production of electricity in California.

2. **The exemption could expire if certain employment figures are not maintained.** The Governor's Budget anticipates decreases in manufacturing employment to cause the exemption to sunset on January 1, 2004. The author may wish to consider extending the sunset date.

   The following table prepared by EDD depicts the total employment in manufacturing (excluding the aerospace industries) for the years 1994 through 2002:

TIME PERIOD	TOTAL MANUFACTURING EMPLOYMENT	INCREASE FROM JANUARY 1, 1994
January 1, 1994	1,650,250	N/A
January 1, 1995	1,585,750	35,500
January 1, 1996	1,642,350	92,100
January 1, 1997	1,694,900	144,650
January 1, 1998	1,763,900	213,660
January 1, 1999	1,744,650	184,400
January 1, 2000	1,761,850	211,800
January 1, 2001	1,814,950	264,700
January 1, 2002	1,694,150	143,900

3. **How far should the current exemption for manufacturers be extended?** Since the original manufacturers' exemption was created in 1993, there have been a variety of measures before the Legislature to broaden that exemption to other segments of industry, such as agricultural, biopharmaceutical, and teleproduction activities. Admittedly, there are numerous borderline activities between manufacturing and other divisions of the classification system. There are some manufacturing-type activities performed by establishments, such as manufacture of software, electricity, and a variety of other activities that are covered in other divisions under the current classification system and consequently, do not fall within the current language of the exemption. Should all these borderline industries be included?

4. **Bill should have a delayed effective date for the sales and use tax exemption.** In general, retailers rely on the Board's "official notice" of tax law changes before they implement any changes to their tax reporting obligations. In order for the Board to timely prepare and mail notices to retailers affected by this measure that may be making sales to power generators, it is suggested that the proposed changes to Section 6377 have a delayed operative date – at a minimum of 30 days after the bill becomes law.

5. **Related legislation.** Numerous measures have been introduced this session to amend Section 6377. These include AB 122 (Calderon), which would extend the conditional sunset date until January 1, 2006; AB 651 (Corbett) which would require a qualifying manufacturer to be certified as a participant in the Career Technical Education Campaign, created by the bill; AB 1674 (Dutra), SB 47 (Ackerman, et al.), SB 137 (Morrow) and SB 2X (Poochigian, et al), all of which would delete the sunset date entirely; and SB 454 (Vasconcellos), which would extend the sunset date based on unspecified job criteria. Further, AB 1665 (Runner) would include all manufacturers (instead of solely new businesses) and also include certain software producers, biopharmaceutical establishments, and telecommunications establishments.

COST ESTIMATE

Enactment of this measure would result in some costs attributable to notifying affected retailers and approving claimed exemptions. These costs are expected to be absorbable.

REVENUE ESTIMATE

This measure would extend the exemption to include the lines of business described in Code 4911 of the Standard Industrial Classification Manual.

Broadening the exemption to include businesses described in Code 4911 of the Standard Industrial Classification Manual would provide an exemption on equipment used in the generation of electricity. Based upon information provided by the US Census Annual Capital Expenditures Survey 2001, the additional expenditures that qualify under this measure are estimated to be $33.0 million.

Revenue Summary

The annual revenue loss from exempting an additional $33.0 million in electrical generation equipment expenditures from the state sales and use tax is as follows:

	Revenue Loss
State (5.00%)	$ 1.7 million

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This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position